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to:

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subject: Treatment of Cost of Seismic Surveys Used to Site Offshore Oil and Gas
: Development Wells

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
A	=
B	=
Region	=
Seismic Survey	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=
<u>e</u>	=

<u>f</u>	=
<u>g</u>	=
<u>h</u>	=
<u>i</u>	=
<u>j</u>	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Date 1	=
Date 2	=
Date 3	=

ISSUE

Whether the cost of seismic surveys used to optimize the placement of offshore oil and gas development wells should be treated as geological and geophysical (G&G) expenditures under § 167(h) or intangible drilling costs (IDCs) under § 263(c) and § 1.612-4(a) of the Treasury Regulations.

CONCLUSIONS

The cost of seismic surveys used to optimize the placement of offshore oil and gas development wells should be treated as geological and geophysical (G&G) expenditures under § 167(h).

FACTS

Taxpayer is engaged in offshore oil and gas drilling and development activities within the United States. Through wholly-owned subsidiaries, Taxpayer owns an a% working interest in the A field and a b% working interest in the B field. The B field was discovered in Year 1 and the A field was discovered in Year 2. The A and B fields are located approximately c miles apart. Taxpayer is the operator of both fields.

Based on information acquired from exploration wells, the joint owners of both fields sanctioned development in late Year 5, including drilling development wells. In Year 6, Taxpayer approved net funding of \$d million for the acquisition of a Seismic Survey of the A and B fields, which covered an area of approximately e offshore blocks (approximately f square miles) within each of the A and B project areas. Taxpayer used

the data generated by the Seismic Survey to optimize placement of development wells in the A and B fields.

Stage 1 development drilling occurred in both fields from Date 1 to Date 2, resulting in g development wells. A development well first produced oil in Year 8. Through the first quarter of Year 9, Taxpayer had drilled h exploratory wells and i development or production wells in the A and B development area. Stage 2 development drilling began on Date 3 and includes j additional wells. The first oil produced from Stage 2 drilling was expected in Year 10.

On its Year 7 tax return, Taxpayer deducted the costs of the Seismic Survey related to the A field as IDCs. Upon Exam, the IRS determined that these costs should be treated as G&G expenditures.

To support its claim for IDCs, Taxpayer presented an authorization for expenditure ("AFE") for the Seismic Survey that stated it was

The AFE also stated that the purpose of the Seismic Survey was to provide better imaging than the seismic data previously obtained in Years 3 and Year 4. Further, the AFE stated that

Taxpayer

also presented a Value of Information ("VOI") summary for the A and B seismic project. The VOI stated that the Seismic Survey

LAW

Geological and Geophysical Expenditures (G&G)

Generally, geological and geophysical ("G&G") expenditures are costs incurred by an oil and gas exploration and production company to obtain, accumulate, and evaluate data that will serve as the basis for the acquisition or retention of oil and gas properties. G&G expenditures are usually associated with a survey, such as a seismic, magnetic, or gravity survey. G&G expenditures can also include the cost of acquiring well logs and core data, sometimes called "bottom-hole data," that pertains to wells drilled by other companies.¹

In recent years the capability of seismic technology has dramatically increased, especially with regard to offshore exploration, drilling and production activities. Data processing and digital imaging have been greatly enhanced by the use of extremely powerful computers and advanced computer modeling techniques. The clarity of seismic surveys has been greatly increased with the advent of "3D" seismic surveys

¹ Internal Revenue Manual 4.41.1.2.2.3.2(1) (December 3, 2013) [hereinafter I.R.M.].

that are achieved by running tightly spaced seismic lines over the entire survey area. In some very large oil fields 3D surveys are conducted periodically (known as “4D” surveys) and evaluated to determine the extent to which fluids have moved within the reservoir over time in response to the withdrawal of oil and gas and the injection of water.²

Historical Tax Treatment

Prior to the enactment of § 167(h) by the Energy Policy Act of 2005, the tax characterization of G&G expenditures was a topic of debate and a source of frustration for the oil and gas industry. From the industry’s perspective, G&G expenditures were viewed as ordinary and necessary business expenses, deductible as part of the costs of the risks taken by the oil and gas industry in exploring for oil needed by the American economy. Conversely, the Treasury and the IRS considered G&G expenditures to be capital in nature and the Courts generally supported that characterization.³

In 1928, the Board of Tax Appeals (BTA) issued *Seletha O. Thompson v. Commissioner*⁴ and *C.M. Nusbaum v. Commissioner*,⁵ requiring the taxpayers to capitalize geological expenditures associated with the acquisition of oil and gas leasehold interests. In 1932, the BTA issued two analogous opinions in *Rialto Mining Corp. v. Commissioner*⁶ and *G.E. Cotton v. Commissioner*⁷ confirming the capitalization requirement in the context of hard minerals extraction.

² I.R.M. 4.41.1.2.2.3.2(2).

³ Joint Committee on Taxation, Description and Technical Explanation of the Conference Agreement of H.R. 6, Title XIII, The “Energy Tax Incentives Act of 2005,” JCX-60-05 No. 3, at 55 n.70 (July 28, 2005) [hereinafter Conference Agreement]. (For purposes of “G&G” expenditures, “property” means an interest in a property as defined in § 614 and includes an economic interest in a tract or parcel of land.)

⁴ *Seletha O. Thompson v. Comm’r.*, 9 B.T.A. 1342, 1345 (January 16, 1928) *citing generally Appeal of McCandless*, 5 B. T. A. 1114 (January 20, 1927); *Gopher Granite Co. v. Comm’r.*, 5 B.T.A. 1216 (January 26, 1927). (Expenditures for surveys, geological opinions, settlement of suits involving title to lands, abstracts of title and legal opinions upon titles are not deductible as ordinary and necessary expenses but are capital expenditures.)

⁵ *C.M. Nusbaum v. Comm’r.*, 10 B.T.A. 664, 665 (February 13, 1928) *citing generally Appeal of Crompton Building Corp.*, 2 B.T.A. 1056 (October 28, 1925); *Appeal of D.N. & E. Walter & Co., Inc.*, 4 B.T.A. 142 (June 21, 1926); *Appeal of McCandless*, 5 B. T. A. 1114 (January 20, 1927). (Amounts paid to a geologist to investigate the presence of oil on a certain tract of land and recommend acquisition were determined to be capital expenditures.)

⁶ *Rialto Mining Corp. v. Comm’r.*, 25 B.T.A. 980, 986 (March 25, 1932) *citing generally Seletha O. Thompson v. Comm’r.*, 9 B.T.A.1342; *Jefferson Gas Coal Co. v. C.I.R.*, 16 B.T.A. 1135 (June 24, 1929). (Taxpayer explored and developed a property but discovered no minerals. Held that expenditures made for the survey and exploration of mining property which the petitioner owned or expected to own and therefore were capital nature.)

⁷ *G.E. Cotton v. Comm’r.*, 25 B.T.A. 866, 869 (March 14, 1932) *citing generally Illinois Central R.R. Co. v. Interstate Commerce Comm.*, 206 U.S. 441 (May 27, 1907). (Held that expenditures made in prospecting a mineral lease must be treated as capital expenditures and added to the cost of the mine when brought to production.)

In 1942, the IRS released Field Procedure Memorandum 241⁸ to its field agents and engineers. The Memorandum required G&G expenditures incurred in the acquisition or retention of oil and gas leases to be capitalized to the property. G&G expenditures not resulting in the acquisition or retention of properties were allowed as ordinary and necessary expenses.

Contemporaneously with the issuance of Field Procedure Memorandum 241, in *Schermerhorn Oil Corp. v. Commissioner*,⁹ the BTA confirmed that G&G expenditures must be capitalized. The BTA held that payments from a net profits interest granted to a geologist in exchange for recommendations on properties for acquisition and development was a cost of acquiring those properties and therefore a capital expenditure.¹⁰ In so holding, the BTA articulated the test for capital expenditures as “whether the expenditures are made in connection with the acquisition or preservation of a capital asset.”¹¹

In 1946, the Tax Court in *Louisiana Land & Exploration Co. v. Commissioner*¹² used the acquisition or retention standard to determine whether geophysical survey costs are capital in nature. The taxpayer owned a property for ten years and then incurred costs for a geological survey to determine whether subsurface structures on the property justified drilling for oil and gas. The Tax Court determined that the cost of the geological survey must be capitalized because it resulted in the acquisition or retention of a capital asset. Importantly, the Tax Court described the point at which acquisition costs end and well development expenses begin:

It thus appears that the results of this survey were to guide petitioner in determining generally whether and to what extent these large areas of land should be explored by drilling wells. Whether or not the scientific knowledge gained from the survey indicated that drilling would be successful or unsuccessful, it was undoubtedly the information upon which would be based further tests and potential drilling operations during the entire period of petitioner's exploitation of the land for oil and gas. This survey was not connected with the drilling of any particular well or wells and was not confined to any restricted area which had been tentatively singled out as the location of a well.¹³

Under these circumstances it seems abundantly clear that the survey was the first step in the over-all development for oil of these tracts of land and

⁸ Field Procedure Memorandum No. 241 (1942).

⁹ *Schermerhorn Oil Corp. v. Comm'r*, 46 B.T.A. 151, 161-162 (1942) citing generally *Helvering v. Winmill*, 305 U.S. 79 (November 7, 1938); *Seletha O. Thompson*, 9 B.T.A. 1342; *Moynier v. Welch*, 97 F.2d 471 (9th Cir., November 7, 1938).

¹⁰ *Id.* at 161.

¹¹ *Id.*

¹² *Louisiana Land & Exploration Co. v. Comm'r*, 7 T.C. 507 (1946), acq. 1946-2 C.B. 3, *aff'd*. 161 F.2d 842 (5th Cir. 1947).

¹³ *Id.* at 515-516, *Cf. Parkersburg Iron & Steel Co. v. Burnet*, 48 F.2d 163, 165 (March 13, 1931).

that the benefit derived from the expenditure was to be enjoyed by petitioner in its business during the entire useful life of the asset being developed.¹⁴

The Tax Court also stated the converse, that IDC activities are “directed to the costs of preparations for the drilling of particular wells after the drilling has been at least tentatively decided upon...”¹⁵

Following the rationale of these cases, in 1950 the IRS issued I.T. 4006,¹⁶ which ruled that G&G exploration costs (a precursor to G&G expenditures) are not deductible as ordinary and necessary business expenses. The ruling stated that such costs are incurred for the purpose of obtaining and accumulating data which will serve as a basis for the acquisition or retention of property. If property is acquired or retained on the basis of data obtained from exploration, costs of exploration attributable to that property should be capitalized as part of the cost of such property. Conversely, if no property is acquired or retained on the basis of such data, the cost of the exploration project is deductible.

In 1977, the IRS issued Revenue Ruling 77-188,¹⁷ which restates and updates the guidance provided in I.T. 4006 regarding the treatment of G&G expenditures. The ruling states that G&G exploration expenditures are those “incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as a basis for the acquisition or retention of property.”¹⁸ The ruling further states that the expenditures attributable to such exploration are allocable as a capital cost to the property or properties acquired or retained. The ruling discusses the allocation of G&G exploration expenditures among areas of interest located and identified as the result of such expenditures. The ruling also states that if no property is acquired or retained within or adjacent to an area of interest, the entire G&G exploration expenditure allocable to the area of interest is deductible as a loss under § 165 for the taxable year in which that particular project area is abandoned as a potential source of mineral production.

For the next three decades the requirement that G&G exploration expenditures be capitalized remained largely unchanged. In Revenue Ruling 80-153¹⁹ the IRS ruled that costs associated with test drilling on another party’s adjoining tract were capitalizable for the taxpayer who contributed to the costs despite the fact that the well was nonproductive and thus ultimately plugged. Although the nonproductive well was not drilled on the taxpayer’s land, the IRS required the contributing taxpayer to capitalize

¹⁴ *Id.*, Cf. *Replier Coal Co. v. Comm’r*, 140 F. 2d 554 (February 19, 1933); *cert. denied*, 323 U.S. 736 (October 8, 1944); *citing generally Rialto Mining Corp.*, 25 B.T.A. at 985.

¹⁵ *Id.* at 516.

¹⁶ I.T. 4006, 1950-1 C.B. 48, *superseded by* Rev. Rul. 77-188, 1977-1 C.B. 76.

¹⁷ Rev. Rul. 77-188.

¹⁸ *Id.* at 2, *citing generally Louisiana Land and Exploration Co.*, 7 T.C. 507; *Schermerhorn Oil Corp.*, 46 B.T.A. 151; *G. E. Cotton*, 26 B.T.A. 866; *C. M. Nusbaum*, 10 B.T.A. 664; and *Seletha O. Thompson*, 9 B.T.A. 1342.

¹⁹ Rev Rul. 80-153, 1980-1 C.B. 10.

the contribution, reasoning that the payment related to the retention of his/her own property. Similarly, in Revenue Ruling 80-342²⁰ several oil companies formed a consortium to drill a Continental Offshore Stratigraphic Test (COST) well and shared the information developed from drilling. The IRS ruled that the expenditures were not IDC but G&G exploration expenditures and must be capitalized by any member of the consortium who obtained a lease within the area of interest.

In 1983, the IRS published Revenue Ruling 83-105²¹ to amplify Revenue Ruling 77-188 by providing significantly greater guidance for the treatment of G&G expenditures. By using seven factual situations this ruling demonstrates the appropriate allocation of G&G expenditures and provides that an “identifiable event” is necessary to establish worthlessness in order to take a loss deduction under § 165 for an abandoned source of mineral production.

Thus, prior to the enactment of § 167(h), G&G expenditures were treated by the IRS and the courts as capital expenditures allocable to the cost of the property acquired or retained and were deducted as a loss if the project was abandoned.

History of Section 167(h)

In the years prior to the enactment of § 167(h), the IRS and taxpayers faced frequent controversies regarding the tax treatment of G&G expenditures. To reduce audit times and increase certainty, the IRS and the oil and gas industry worked together to promote a statutory treatment for G&G expenditures. The result was the enactment of § 167(h) the “Amortization of Geological and Geophysical Expenditures” in the Energy Policy Act of 2005.²²

The General Explanation of Tax Legislation Enacted in the 109th Congress (Bluebook) describes Congress’ reasons for enacting § 167(h) as seeking “substantial simplification for taxpayers, significant gains in taxpayer compliance, and reductions in administrative cost [that] can be obtained by establishing a clear rule that all geological and geophysical costs may be amortized over two years, including the basis of abandoned property.”²³ The Bluebook also indicates that when enacting § 167(h), Congress recognized that providing favorable treatment for such costs would foster increased exploration for new sources of oil and gas.²⁴

Although § 167(h) changes the treatment of G&G expenditures from capitalization to amortization it does not define the term “geological and geophysical expenditures.” Rather, the legislative history of § 167(h) demonstrates Congress’ intention to adopt

²⁰ Rev. Rul. 80-342, 1980-2 C.B. 99.

²¹ Rev. Rul. 83-105, 1983-2 C.B. 51.

²² P.L. 109-58, § 1329(a), 119 Stat. 594 (August 8, 2005).

²³ Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress, JCS-1-07 No. 6 at 51-52 (January 17, 2007) [hereinafter Bluebook].

²⁴ *Id.*

the long-standing definitions of the income tax terms used in § 167(h).²⁵ Consistent with the definition of G&G expenditures contained in prior case law and IRS guidance, the Bluebook states that “[g]eological and geophysical expenditures (“G&G costs”) are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals.”²⁶

Additionally, the Conference Agreement prepared for the Energy Policy Act of 2005 (Conference Agreement)²⁷ provides significant background on the tax treatment of G&G expenditures before the enactment of § 167(h). This Report summarizes the most important IRS guidance regarding the tax treatment of G&G expenditures and gives the reader insight into the interpretation of the operative terms in § 167(h). Importantly, the Conference Agreement effectively incorporates the IRS’ positions in Revenue Ruling 77-188 and Revenue Ruling 83-105.

Amortization of Geological and Geophysical Expenditures - Section 167(h)

Section 167(h)(1) provides for any G&G expenditures paid or incurred in connection with the exploration for, or development of, oil or gas within the United States (as defined in § 638)²⁸ to be allowed as a deduction ratably over the 24-month period beginning on the date that such expense was paid or incurred.

Section 167(h)(2) requires that any payment paid or incurred during a taxable year be treated as having been paid or incurred on the mid-point of that tax year.

Section 167(h)(3) states that no other depreciation or amortization deduction is allowable with respect to qualified G&G expenditures.

Section 167(h)(4) provides that if any property with respect to which G&G expenditures are paid or incurred is retired or abandoned during the 24-month period, no deduction is allowed on account of such retirement or abandonment and the amortization deduction continues with respect to such payment.

Section 167(h)(5)(A) provides that in the case of major integrated oil companies,²⁹

²⁵ Conference Agreement, *supra* note 2, at 55-57.

²⁶ Bluebook, *supra* note 24, at 49.

²⁷ Conference Agreement, *supra* note 2, at 55-57.

²⁸ Section 638 provides that the term “United States” includes the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources.

²⁹ Section 167(h)(5)(B) defines a “major integrated oil company” as, with respect to any taxable year, a producer of crude oil-- (i) which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year; (ii) which had gross receipts in excess of \$1,000,000,000 for its last taxable year ending during calendar year 2005; and (iii) to which subsection (c) of section 613A does not apply by reason of paragraph (4) of section 613A(d), determined-- (I) by substituting “15 percent” for “5 percent”

§ 167(h)(1) is to be applied by substituting “7-year” for “24-month.”³⁰

IRS Interpretation of Section 167(h)

The IRS also has applied case law and prior IRS guidance in interpreting § 167(h). In CCA 201552024,³¹ the IRS concluded that a taxpayer that acquires seismic data as part of an asset acquisition has not paid or incurred G&G expenditures within the meaning of § 167(h). The seller had acquired non-producing leases and used the seismic data to drill wells, many of which were successful and producing at the time of the acquisition by the taxpayer. Although, at the time of the acquisition by taxpayer, there were still undeveloped properties within the area, many were offset locations directly adjacent to existing productive wells that were considered proved or probable reserves. After the acquisition, the taxpayer amortized the allocated value of the seismic data as G&G expenditures under § 167(h). The CCA noted that case law and prior IRS guidance have consistently defined G&G expenditures as “costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals.”³² Because Taxpayer acquired properties that were either developed or proved or probable, Taxpayer did not incur costs to locate and identify properties with the potential to produce commercial quantities of oil and natural gas. In other words, Taxpayer did not incur costs to obtain and accumulate data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. Therefore, the IRS concluded that the Taxpayer did not pay or incur G&G expenditures within the meaning of § 167(h).

Judicial Interpretation of Section 167(h)

The first judicial interpretation of § 167(h) was the Tax Court’s decision in *CGG Americas, Inc. v. Commissioner*.³³ In tax years 2006 and 2007, the taxpayer, an oil and gas services company, conducted geophysical surveys and processed and licensed the resulting data to various oil and gas companies on a non-exclusive basis. Relying on § 167(h), the taxpayer amortized the cost of the geophysical surveys over 24

each place it occurs in paragraph (3) of section 613A(d), and (II) without regard to whether subsection (c) of section 613A does not apply by reason of paragraph (2) of section 613A(d). For purposes of clauses (i) and (ii), all persons treated as a single employer under subsections (a) and (b) of section 52 shall be treated as 1 person and, in case of a short taxable year, the rule under section 448(c)(3) (B) shall apply.

³⁰ Section 167(h) was subsequently amended by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. 109-222, § 503(a), 120 Stat. 345 (May 17, 2006) by adding § 167(h)(5)(B) to extend the 24-month amortization period to five years for G&G expenditures paid or incurred by major integrated oil companies after May 17, 2006. Section 167(h) was further amended by the Energy Independence and Security Act of 2007, Pub. L. 110-140, § 1502(a), 121 Stat. 1492 (December 19, 2007) by extending the five year amortization period to seven years for G&G expenditures paid or incurred by major integrated oil companies after December 19, 2007.

³¹ I.R.S. CCA 201552024 (Dec. 24, 2015).

³² *Id.* citing I.T. 4006; Revenue Ruling 77-188.

³³ *CGG Americas, Inc. v. Comm’r*, 147 T.C. 78 (July 21, 2016).

months. On audit, the IRS asserted that the taxpayer did not qualify to use § 167(h) because the geophysical data that it collected and licensed was used by other companies for *their* exploration and development of oil and gas. The IRS argued that while § 167(h) contains no requirement that taxpayer engage in the exploration for, or development of, oil or gas *itself*, that pre-codification case law, administrative rulings and legislative materials supported this requirement.

The Tax Court determined that “although the legislative materials involving § 167(h) show that its supporters were concerned about mineral-interest owners, the material didn’t show they intended the provision’s effect to be limited to solely mineral-interest owners.”³⁴ The Tax Court concluded that the taxpayer had incurred G&G expenditures in connection with oil and gas exploration because its activities were integral to its clients finding oil and gas deposits. As a result, the taxpayer was found eligible to amortize its expenditures as G&G under § 167(h).

Intangible Drilling Costs (IDCs)

Law

Section 263(c) directs the Treasury to issue regulations permitting taxpayers to elect to deduct IDCs, without describing or defining the costs affected by the election, except to state that the regulations must correspond “to the regulations... which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-Ninth Congress.” The option codified in § 263(c) to expense or capitalize IDCs (IDC option) operates as an incentive to encourage capital investment in the development of oil and gas properties.³⁵ This incentive has existed since the first income tax statute, although it existed as a regulation unsupported by statutory authority until 1954.

In 1945, the Court of Appeals for the Fifth Circuit held in *F.H.E. Oil Co. v. Commissioner*,³⁶ that the regulations permitting the IDC option were invalid because the statutory predecessor of § 263(a) prohibited any deduction for the cost of “permanent improvements or betterments made to increase the value of any property or estate.”³⁷ Within weeks of the *F.H.E. Oil Co.* decision, Congress shored up the regulations by enacting House Concurrent Resolution 50³⁸ declaring that Congress “has recognized and approved” the disputed regulations.³⁹

³⁴ *Id.* at 105-06.

³⁵ *Exxon Corp. v. U.S.*, 547 F.2d 547, 555 (Ct. Cl. 1976). (“Congress has consistently viewed the optional treatment of IDC as an incentive to oil and gas prospecting and exploration, clearly a continuing objective of national importance.”)

³⁶ *F.H.E. Oil Co. v. Comm’r*, 147 F.2d 1002 (5th Cir., March 6, 1945) (regulations held invalid), *reh’g denied*, 149 F.2d 238 (5th Cir. May 4, 1945), *second reh’g denied*, 150 F.2d 857 (5th Cir. August 21, 1945).

³⁷ *Id.* at 1003.

³⁸ H.R. Con. Res. 50, 79th Cong. (1945).

³⁹ H.R.Rep. No. 761, 79th Cong., 1st Sess. 2 (1945). (Accompanied Resolution 50 and provides that § 263(c) was enacted because “[t]he uncertainty occasioned by raising doubts as to the validity of these [predecessor] regulations is materially interfering with the exploration for and the production of oil...”)

Historical Attempts to Define IDCs

Traditionally, exploration costs end and well development costs begin at the point when the operator determines the location for the drilling of the well. In *Louisiana Land & Exploration Co.*,⁴⁰ the Tax Court described the point at which acquisition costs end and well development expenses [also known as IDCs] begin as “the costs of preparations for the drilling of particular wells after the drilling has been at least tentatively decided upon, which preparations are far removed from over-all geophysical exploration such as we are here considering.”⁴¹

In recent years the capability of seismic technology has increased dramatically, especially in regards to offshore exploration, drilling and production activities.⁴² This innovation has increasingly blurred the distinction between exploration and development costs contributing to controversies regarding the proper characterization of the costs of offshore oil and gas exploration. What may now be accomplished by more sophisticated seismic technology previously could be accomplished only by drilling exploratory wells and similar invasive methods.

For years, the IRS took the position that the IDC option was not available where offshore exploration wells were plugged and abandoned.⁴³ The IRS asserted that that the taxpayer’s main purpose in drilling exploration wells was to obtain geological data to assess the property and that taxpayer had no intention of completing the wells. As a result, the IRS asserted that such wells were drilled before the taxpayer decided to commence development and were actually G&G expenditures.⁴⁴

For example, in *Standard Oil Co. (Indiana) v. Commissioner*,⁴⁵ the taxpayer drilled test wells in numerous locations on an offshore lease. Each of the test wells was drilled to ascertain the existence, type, quality, and quantity of hydrocarbons and if promising, completed as a producing well. The IRS asserted that the drilling of offshore exploratory wells from mobile drilling rigs was merely an extension of exploratory operations similar to geological and geophysical surveys for which the costs must be capitalized. Further, the IRS argued that development did not begin until an operator of an offshore oil and gas property *made the decision* to commence development drilling (the time the decision was made to install a permanent drilling and production platform).⁴⁶ The IRS asserted that until such decision is made, all costs of exploratory wells must be capitalized.

In *Standard Oil Co.*, the Tax Court rejected the IRS’ arguments, reasoning that “the

⁴⁰ See generally, *Louisiana Land & Exploration Co.*, 7 T.C. 507.

⁴¹ *Id.* at 515-516.

⁴² I.R.M. 4.41.1.2.2.3.2(2).

⁴³ *Exxon Corp.*, 547 F.2d at 548.

⁴⁴ *Id.*

⁴⁵ *Standard Oil Co. (Indiana) v. Comm’r*, 68 T.C. 325, 353-354 (June 7, 1977), *acq.* 1983-2 C.B. 1.

⁴⁶ *Id.* at 348 (emphasis added).

classification of the activities in issue as ‘exploratory’ lends no support to [the IRS’] position... Both the terms ‘exploratory’ and ‘development’ have been used in a broad sense in the field of oil and gas taxation. Both terms have been used to describe activities which must be capitalized, such as seismic surveys, as well as operations which clearly fall within the IDC option.”⁴⁷ Therefore, “the classification of an activity as exploratory does not necessarily carry with it the requirement of capitalization.”⁴⁸ The Tax Court further held that “it is clear from the language of the regulations” and the holding of this Court in *Louisiana Land & Exploration Co.* “that the dividing line between ‘exploratory’ work which must be capitalized and ‘development’ activities coming within the IDC option is the *point at which the preparations for drilling begin*.”⁴⁹ The Tax Court emphasized that “there is nothing in the regulations which either expressly or implicitly limits the ‘wells’ to those drilled *after a decision* has been made to install a permanent drilling and production platform. To so hold would be inconsistent with the long-standing construction and natural meaning of the regulations.”⁵⁰ Accordingly, the Tax Court concluded that as long as the well could actually produce oil or gas if so desired, the requirements to claim IDCs have been met.

The IRS continued to assert the position that costs of drilling offshore wells must be capitalized as G&G expenditures. The Tax Court rejected the IRS’ position in *Sun Co., Inc. & Subs v. Commissioner*⁵¹ and *Gates Rubber Co. & Subs v. Commissioner*.⁵² In both cases, the Tax Court considered whether the costs of drilling offshore wells by mobile offshore drilling rigs may be treated as IDCs. The facts of these cases differed from those in *Standard Oil Co.* because in that case most of the wells drilled were capable of commercially producing petroleum products. In *Sun Co.* and *Gates Rubber* many of the wells were dry holes and were plugged and abandoned. It was with respect to these wells that the IRS argued that because no intent to produce existed, the wells were merely exploratory wells and the costs were not within the IDC option.⁵³ In *Gates Rubber*, the Tax Court responded that “[w]e reiterate our clear-cut holding in the *Standard Oil Co.* case on the matter of intent: ‘The answer to respondent’s contention is simply that the regulations contain no requirement of an intention to complete and produce a particular well.’”⁵⁴

In 1978, the IRS issued TAM 7837004,⁵⁵ considering whether costs incurred in drilling bore holes to determine the extent and existence of an offshore deposit may be treated as IDCs. The IRS reasoned that while the IDC option includes expenditures for

⁴⁷ *Id.* at 346.

⁴⁸ *Id.* at 349.

⁴⁹ *Id.* at 347 (emphasis added).

⁵⁰ *Id.* at 348 (emphasis added).

⁵¹ *Sun Co., Inc. & Subs v. Comm’r*, 74 T.C. 1481 (September 25, 1980), *acq.* 1983-1 C.B. 1, *aff’d*, 677 F.2d 294 (3rd Cir., April 16, 1982).

⁵² *Gates Rubber Co. & Subs v. Comm’r*, 74 T.C. 1456 (September 25, 1980), *acq.* 1983-1 C.B. 1, *aff’d*, 694 F.2d 648 (10th Cir., December 3, 1982).

⁵³ *Id.* at 1478-1479.

⁵⁴ *Id.* at 1479 *quoting Standard Oil Co.*, 68 T.C. at 351-352.

⁵⁵ I.R.S. TAM 7837004 (January 1, 1978).

geological works as are necessary in the preparation for the drilling of wells, in this case, the taxpayer drilled the bore holes to determine the extent and existence of the deposit, and to obtain a guide to the *optimum location and number of drainage points, and the number and location of platforms*, if any, that would be constructed.⁵⁶ As a result, such costs incurred in determining whether and how to develop the block were not connected with the drilling of *any particular well*.⁵⁷ The IRS concluded that because the IDC option is directed to the costs of preparation for the drilling of *a particular well* after drilling has at least been tentatively decided upon the costs incurred in drilling the bore holes are not within the IDC option.⁵⁸

The IRS began to change its treatment of offshore IDCs with the issuance of Revenue Ruling 88-10.⁵⁹ In that ruling the IRS determined that the costs incurred to drill expendable bore holes to determine the location and delineation of offshore hydrocarbon deposits (and which were capable of conducting hydrocarbons to the surface on completion) are within the option to expense IDC, regardless of whether there is an intent to produce hydrocarbons.

In 2013, the IRS updated the Oil and Gas Industry Handbook, which includes Exhibit 4.41.1-5 “Classification of Expenditures in Acquisition, Development, and Operation of Oil and Gas Leases.”⁶⁰ This Exhibit lists as leasehold costs (and therefore capital expenditures) both “geological and geophysical expenditures leading to acquisition or retention of an oil and gas property” and “the cost of seismic work incurred by an oil and gas company to determine the size of the reservoir or reserves.” The Exhibit also lists as Intangible Drilling Costs (and therefore deductible expenditures) “survey and seismic costs to locate a well site on leased property.”

Current Law

Section 263(a) provides that no deduction is allowed for capital expenditures. However, notwithstanding the provisions of § 263(a), § 263(c) allows a taxpayer an election, under regulations prescribed by the Secretary, to expense intangible drilling costs (IDCs). Those regulations are set forth in Treasury Regulations § 1.612-4.

⁵⁶ *Id.* (emphasis added).

⁵⁷ *Id.* citing generally, *Louisiana Land and Exploration Co.*, 7 T.C. 507 (emphasis added).

⁵⁸ *Id.* (emphasis added). (Later the same year, the IRS issued TAM 7834002 applying the same conclusion to similar facts. In that ruling, the IRS observed that the Tax Court in *Standard Oil Co.* “misreads the regulations in stating that the regulations contain no requirement of an intention to complete and produce a particular well. The court leaves out of the reading of the regulations the phrase, ‘and the preparation of the wells for production.’”)

⁵⁹ Rev. Rul. 88-10, 1988-1 C.B. 112.

⁶⁰ I.R.M. Exhibit 4.41.1-5.

Section 1.612-4(a) provides that IDCs incurred by an operator⁶¹ in the development of oil and gas properties may at his option be chargeable to capital or to expense. If the taxpayer chooses to expense IDCs, the taxpayer also has an option to elect to amortize the IDCs ratably over 60 months under § 59(e).

Section 1.612-4(a) applies to all expenditures made by an operator incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. These costs include costs incurred by operators of any drilling or development work performed for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, which are used:

- (1) In the drilling, shooting, and cleaning of wells;
- (2) In such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and
- (3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

Additionally, 1.612-4(a) provides that in general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value.

Under § 1.612-4(b)(4), if a taxpayer elects to capitalize IDCs, then an additional election (within an election) is available to deduct as an ordinary loss those costs incurred in drilling a non-productive well. A taxpayer must make a proper election on the return for the first taxable year in which the nonproductive well is completed.

Under § 1.612-4(c), the IDC option does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc.

Under § 1.612-4(d), a taxpayer may exercise the election to expense IDCs by claiming IDCs as a deduction on the taxpayer's return for the first taxable year in which the taxpayer pays or incurs such costs. A taxpayer's failure to deduct IDC in such taxable year is treated as an election to capitalize such costs and recover them through depreciation or depletion.

⁶¹ Treas. Reg. § 1.612-4(a) defines an operator as one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights.

Additionally, under § 291(b)(1), otherwise allowable IDCs that have been expensed by an integrated oil company are cut back by 30 percent.⁶² Under § 291(b)(2), the remaining 30 percent is deductible ratably over the 60 month period beginning with the month in which the costs are paid or incurred. This provision significantly reduces the benefit of the IDC option to integrated oil companies.

ANALYSIS

Taxpayer incurred costs for the acquisition of a Seismic Survey of the A and B fields. The Seismic Survey covered an area of interest within each of the A and B project areas. Taxpayer used the data generated by the Seismic Survey to optimize placement of development wells in the A and B fields. Taxpayer deducted the costs of the Seismic Survey related to the A field as IDCs. Upon Exam, the IRS determined that the costs that Taxpayer incurred to acquire the Seismic Survey should be treated as G&G expenditures.

Plain Meaning of Section 167(h) Includes Developmental G&G

Section 167(h)(1) provides that any geological and geophysical expenditures paid or incurred in connection with the exploration for, or development of, oil or gas within the United States (as defined in § 638) are to be allowed as a deduction ratably over the 24-month period beginning on the date that such expense was paid or incurred. The inclusion of the phrase “or development of” specifically indicates that Congress intended to include the cost of geological and geophysical expenditures during the development phase of an oil and gas project.

The function of geological and geophysical activities is to locate and identify properties with the potential to produce commercial quantities of oil and natural gas, as well as to determine the optimal location for exploratory and developmental wells. These costs are an important and integral part of exploration and production for oil and natural gas. Traditionally, G&G expenditures are associated with a survey, such as a seismic, magnetic, or gravity survey conducted by a specialized service company. These expenditures can also include the cost of acquiring well logs and core data, sometimes called “bottom-hole data,” which pertains to wells drilled by other companies.

The application of the plain language of § 167(h) to our case is straightforward. The Seismic Survey was conducted over a significant area of interest within two project areas. It involved no drilling and was not used to site specific wells. The costs of the Seismic Survey were “incurred in connection with the exploration for, or development of, oil or gas within the United States (as defined in § 638).” Therefore, the costs are geological and geophysical expenditures within the meaning of § 167(h).

⁶² Section 291(b)(4), by cross reference to § 613A(d)(2) and (4), defines an “integrated oil company” as a taxpayer, whose combined gross receipts (or those of a related person) from retail sales of oil, natural gas, or any product derived therefrom, for the taxable year exceed \$5,000,000 or whose refinery runs (or those of a related person) exceed 50,000 barrels on any day during the taxable year.

Section 167(h)(3) provides an exclusive method of cost recovery for G&G expenditures. Except as provided within § 167(h), no depreciation or amortization deduction is allowed with respect to such payments.

Legislative History of § 167(h) Does Not Exclude Developmental G&G

Although § 167(h) changes the prior tax treatment of G&G expenditures, it does not define the term “geological and geophysical expenditures.” Rather, the legislative history of § 167(h) makes clear Congress’ intention to adopt the long-standing income tax definitions of the terms used in § 167(h). Consistent with the definition of G&G expenditures contained in case law and prior IRS guidance, the legislative history reflects Congress’ adoption of the definition of G&G expenditures as “costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties.”⁶³

While the term exploration has often been associated with G&G expenditures the term development has had very little prior association with G&G expenditures apart from the Tax Court’s observations in *Louisiana Land and Exploration Co.* that a geophysical survey was the “first step in the over-all development for oil of these tracts of land.”⁶⁴ Additionally, the Tax Court in *Standard Oil Co.* stated that “[b]oth the terms ‘exploratory’ and ‘development’ have been used in a broad sense in the field of oil and gas taxation. Both terms have been used to describe activities which must be capitalized, such as seismic surveys, as well as operations which clearly fall within the IDC option.”⁶⁵

We interpret the terms “exploratory” and “development” as interchangeable where the same types of activities occur in both phases. As a result, while the legislative history of § 167(h) generally refers to G&G expenditures as costs attributable to exploration activities, the definition of G&G expenditures can extend to the same activities that occur within the development phase of an oil and gas project.

In the Conference Agreement that accompanied the enactment of § 167(h), Congress relied heavily upon prior IRS administrative rulings noting that they “have provided further guidance regarding the definition and proper tax treatment of G&G costs.”⁶⁶ The Conference Agreement discusses in detail the guidance provided in Revenue Ruling 77-188,⁶⁷ which describes a typical G&G exploration program as containing certain activities. The ruling describes the activities undertaken by a taxpayer conducting an exploration program in one or more identifiable project areas. The taxpayer selects a specific project area from which G&G data are desired to conduct a reconnaissance-type survey utilizing various G&G exploration techniques. These techniques are designed to yield data that will afford a basis for identifying specific geological features

⁶³ Conference Agreement, *supra* note 2, at 55 (emphasis added).

⁶⁴ *Louisiana Land and Exploration Co.*, 7 T.C. at 516.

⁶⁵ *Standard Oil Co.*, 68 T.C. at 346.

⁶⁶ Conference Agreement, *supra* note 2, at 55.

⁶⁷ *Id.* at 55-57.

with sufficient mineral potential to merit further exploration. Each separable, noncontiguous portion of the original project area in which such a specific geological feature is identified is a separate “area of interest.” The taxpayer seeks to further define the geological features identified by the prior reconnaissance-type surveys by additional, more detailed, exploratory surveys conducted with respect to each area of interest. For this purpose, the taxpayer engages in more intensive geological and geophysical exploration employing methods that are designed to yield sufficiently accurate sub-surface data to afford a basis for a decision to acquire or retain properties within or adjacent to a particular area of interest or to abandon the entire area of interest as unworthy of development by mine or well.

While Revenue Ruling 77-188 refers to this sequence of events as an exploration program, this last phase of activity is analogous to the Seismic Survey undertaken by Taxpayer in this case. Revenue Ruling 77-188 states that the taxpayer may acquire *or retain* a property within or adjacent to an area of interest, based on data obtained from a detailed survey that does not relate exclusively to any discrete property within a particular area of interest. Revenue Ruling 77-188 requires the taxpayer in this situation to allocate the entire amount of G&G costs to the acquired or retained property as a capital cost under § 263(a). With the enactment of § 167(h) as the exclusive method for recovering G&G expenditures, the costs of the Seismic Survey are G&G expenditures within the meaning of § 167(h).

Case Law Includes Developmental G&G

The present case is analogous to *Louisiana Land & Exploration Co. v. Commissioner*.⁶⁸ As discussed above, in that case, the Tax Court used the acquisition or retention standard to determine whether geophysical survey costs are capital in nature. The taxpayer owned a property for ten years and then incurred costs for a geological survey to determine whether subsurface structures on the property justified drilling for oil and gas. The Tax Court determined that the cost of the geological survey must be capitalized because it resulted in the acquisition or retention of a capital asset. Importantly, the Tax Court noted that “[t]his survey was not connected with the drilling of any particular well or wells and was not confined to any restricted area which had been tentatively singled out as the location of a well.”⁶⁹ Conversely, the Tax Court noted that the IDC option “is directed to the costs of preparations for the drilling of particular wells after the drilling has been at least tentatively decided upon, which preparations are far removed from over-all geophysical exploration such as we are here considering.”⁷⁰

In the present case, the A field was discovered over a decade before development began. An earlier set of surveys were conducted years before Taxpayer incurred costs to acquire the Seismic Survey. The Seismic Survey generated data from a broad area of the seafloor within two distinct project areas. Taxpayer then used the data generated

⁶⁸ See generally, *Louisiana Land & Exploration Co.*, 7 T.C. 507.

⁶⁹ *Id.* at 515-516, *Cf. Parkersburg Iron & Steel Co. v. Burnet*, 48 F.2d at 165.

⁷⁰ *Id.*

by the Seismic Survey to optimize placement of development wells in the A and B fields. Taxpayer did not use this data to prepare for the drilling of a specific well or wells but to determine where generally to drill within two project areas. Accordingly, under the rationale of *Louisiana Land & Exploration Co. v. Commissioner*, the costs that Taxpayer incurred to acquire the Seismic Survey are G&G expenditures.

IDC Option is Not Applicable to Tangible Property Having a Salvage Value

Additionally, under § 1.612-4(c), the IDC option does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. In the present case, Taxpayer incurred costs to acquire the data generated by a Seismic Survey. If such data was exclusively licensed or sold to Taxpayer in some tangible form, the cost of the acquisition could not qualify as IDCs.⁷¹

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

⁷¹ For example, in *Texas Instruments Inc. v. U.S.*, 551 F.2d 599 (5th Cir., April 27, 1977) and *Texas Instruments Inc. v. Comm'r.*, 98 T.C. 628 (May 27, 1992), the courts considered the issue of whether a taxpayer that acquires data generated by seismic surveys is purchasing intangible data or tangible property. Both cases considered this issue in the context of the investment tax credit.

[REDACTED]

[REDACTED]

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Please call (202) 317-6853 if you have any further questions.